Effective Management of Debt Finance for Local Government

This information aims to provide an overview of the appropriate use of debt finance for local government and the requirement for a market valuation when refinancing or making unscheduled repayments on fixed interest rate loans, to assist in making informed decisions when considering debt finance from WATC.

Introduction

The majority of Western Australian Local Government Authorities (LGAs) maintain a portfolio of fixed-interest rate loans with Western Australian Treasury Corporation (WATC). These are generally long-term amortising loans (e.g. 10 years or longer) where the interest rate was fixed at the time the loan was taken out. Payments of interest and capital for the life of the loan are determined at the time the loan is drawn.

Fixed-interest rate loans provide the benefit of certainty of financing costs over the long term, which assists with project costing and budgeting for future repayment obligations. It also protects the borrower from increases in the general level of interest rates. However, if interest rates fall over time, the borrower will be left with a financing commitment at a higher interest rate than the rate currently available.

Appropriate Use of Debt Finance

LGAs primarily borrow from WATC to fund infrastructure development for the communities they support. Long-term loans are raised for the development of specific community assets with repayment being tied to the primary sources of income for LGAs – principally rates.

However, some councils direct their LGAs to have a no-debt policy or a policy whereby a loan can only be raised on the basis that it is expected to be repaid by an independent source of revenue, for example, property development projects.

An LGA with a no-debt policy may regard itself as financially conservative or not wanting to burden its constituents with debt. However, such a policy is not consistent with achieving an appropriate balance in intergenerational equity. As such, it may negatively impact the level of service provided to the current community and/or be associated with significant asset degradation and increasing allocation to maintenance costs.

Furthermore, LGAs that only borrow where they expect an independent source of revenue to service the loan are subjecting themselves, and ultimately their rate payers, to a higher degree of financial risk. This arises as the alternate income streams expected to support such loans are generally subject to a degree of uncertainty in comparison to an LGA's core sources of income (i.e. rates and regular grants).

To assist our LGA clients in considering the appropriate use of debt as a possible source of finance for the future development of community infrastructure, WATC has developed the Indicative Additional Borrowing Capacity Calculator. This calculator is designed to be inserted within an LGA's long-term financial planning model and, based on prudent debt-servicing assumptions, provides an indication of the likely capacity of an LGA to use debt for future capital projects.

Refinancing and Unscheduled Repayments of Fixed Interest Rate Loans

With market interest rates currently at record lows, WATC's LGA clients often enquire about the possibility of restructuring (i.e. refinancing) existing fixed-interest rate loans that have significantly higher interest rates with a replacement loan at the current market interest rate which is considerably lower.

Often at the request of council, LGAs enquire about the possibility of repaying loans early to take advantage of low interest rates, as is frequently portrayed in the media where householders are doing so to get ahead on their mortgages. However, household mortgages are predominantly variable-rate loans and therefore unscheduled repayments are not subject to a market valuation adjustment as explained below.

Market Valuation Adjustment

WATC is able to restructure existing fixed-interest rate loans prior to their maturity date and/or accept any unscheduled repayments of capital at the request of the borrower. However, to do so requires determination of the current market value of the existing loan. The market valuation of a loan will depend on the interest rate prevailing at the time of valuation compared with the original interest rate and the length of time remaining to the maturity date of the original fixed-interest rate loan.

A market valuation involves valuing the previously committed fixed-payment schedule at the current interest rate for the remaining term of the loan. This form of valuation is required because, where a borrower elects to restructure and/or make unscheduled payments (in full or in part), WATC must make the equivalent adjustments with the market counterparties through which WATC sourced the funds for the original loan.

If interest rates have fallen since the original loan and the borrower wishes to repay part or all of the loan, the market counterparty must be compensated for the foregone interest being paid on the original loan, as they will not be able to reinvest the repaid funds at the same rate – hence a capital premium will be payable.

Conversely, if interest rates have increased since the original loan, a market counterparty will be prepared to receive a reduced amount of the outstanding capital (i.e. provide a discount) as they will be able to reinvest the repaid funds at a higher interest rate.

Therefore, where WATC communicates to a client that a premium is payable when requesting a loan restructure or unscheduled repayment on an existing fixed-interest rate loan, this represents the 'fair price' implied by the market valuation in that it reflects the prevailing market interest rates that could be received from investing the early repayment of debt. Clients may often interpret such a premium as an 'early termination fee', 'break fee' or some other such cost imposed by WATC. This is not the case as WATC derives no financial benefit from these transactions. This may differ from private financial institutions that may levy such fees in conjunction with a market valuation adjustment.

Accessing WATC Services

Our services are available to all Western Australian State government entities, local governments and public universities. Contact us to discuss your specific business requirements.

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